STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 2001-572

November 13, 2001

NORTHERN UTILITIES, INC.,
Proposed Cost of Gas
Factor for the 2001 - 2002
Winter Period and Annual
Environmental Recovery Cost
Adjustment

SUPPLEMENTAL ORDER

WELCH, Chairman; NUGENT and DIAMOND, Commissioners

I. SUMMARY

We will review the question of whether we should establish a general policy on allowing local distribution companies (LDCs) to hedge without explicit regulatory guidelines, as well as Northern Utilities, Inc.'s (Northern) proposed hedging program filed September 30, 2001, in greater detail in the docket we have assigned to the hedging program filing, Docket No. 2001-679.

II. BACKGROUND

A. Procedural History

In our October 29, 2001 Order in this docket, we approved Northern Utilities, Inc.'s (Northern) proposed Cost of Gas Factor (CGF) for the 2001 - 2002 winter period and an Environmental Response Cost Adjustment (ERCA). An Examiner's Report issued October 18, 2001 addressed Northern's hedging activities and policies to date.[1] Northern filed exceptions on this issue only, and we discussed the matter at our deliberations on October 29, 2001. As the issue does not affect our approval of the proposed rates for this winter season, we determined that we would reserve and further develop our comments on the issue in a supplemental order.

B. Gas Market History

Prior to 1999, natural gas market prices were very stable, in recent years remaining close to $2.00 per Mcf. From 1999 through the second quarter of 2001, the nation experienced dramatic increases in natural gas prices, exceeding $10.00 per Mcf in December 2000. During the 1999-2001 period, we approved cost of gas factor increases for Northern in six out of eight changes. The percentage changes for residential customers were:

[1] The Hearing Examiner issued an errata sheet on October 23, 2001.

CGF Period	Docket		% Change
Winter 1999-2000	99-586	Order	n/a[2]
		Mid-Course	11.85%
Summer 2000	2000-140	Order	-3.10%
		Mid-Course	18.78%
Winter 2000-2001	2000-680	Order	23.45%
		Mid-Course	11.35%
Summer 2001	2001-118	Order	16.85%
		Mid-Course	-20.92%
Winter 2001-2002	2001-572	Order	0.19%

As shown in the above table, mid-course adjustments to the seasonal cost of gas factor adjustment were necessary in four successive periods, both summer and winter, to keep pace with market prices. In the summer of 2000, we saw an unprecedented rate anomaly when Northern's summer season rates exceeded the rates of the prior winter season.[3]

The rate increases were driven by market forces, including the confluence of strong increases in demand, in part from new gas-fired power generation, and reduced supplies. Local distribution companies across the nation experienced commodity rate increases consistent with, or even higher than, Northern's, followed by high utility uncollectible amounts and customer disconnections. Both the regulatory community and the industry have increasingly focused on the use of financial hedging instruments, customer pricing options, and other means to attempt to mitigate market price swings such as occurred during the 1999-2000 time period.

In December 2000, we directed Northern

> …to comment on the possibility of providing fixed-price contracts, implementing price hedging mechanisms, or other

[2] Because Northern's prior period cost of gas was calculated using a different rate design we were unable to calculate a comparable percentage change for the purposes we have outlined here. However, commodity costs also increased in that period.

[3] Normally, summer period gas costs are significantly lower than winter season gas costs. During the period of market price escalation, the summer and winter rate levels converged and, ultimately, the 2000 summer rate exceeded the prior winter rate.

> options that would assist customers to mitigate the effects of the volatility of the gas markets …. by January 19, 2001.

See *Northern Utilities, Inc., Proposed Cost of Gas Factor for the 2000/2001 Winter Period – Mid-Course Correction,* Docket No. 2000-680, Order (Dec. 28, 2000) at 3.

Northern filed a written response in which it reported that it maintains significant price diversity within its portfolio.

> Northern is able to temper price volatility by utilizing underground storage and peaking resources while allowing its sales customers some flexibility to participate in the potential downside of the market. While Northern has considered the use of financial instruments to hedge gas supplies in the past, it chose instead to develop a resource portfolio that accomplishes hedging primarily through the use of physical assets.

See Northern Response filed in Docket No. 2000-680, dated January 18, 2001 at 1-2. Northern indicated it would continue to explore financial hedging as a supplemental means to protect against future price volatility.

In its response, Northern noted that the New Hampshire PUC staff had expressed an interest in having Northern employ financial hedging tools and provide a fixed price option program. Northern proposed a meeting with Maine and New Hampshire PUC staff members because it manages its gas supply portfolio to meet the needs of customers in both states. At the meeting, held on February 16, 2001, Northern contended that the large quantity of storage gas in its portfolio gives it greater protection from winter market price than is the case for other LDCs in the Maine, New Hampshire, and Massachusetts region.

In May, however, Northern contacted MPUC staff, indicating that it was preparing to execute a financial hedge within the next few days and asking how the Commission would view such an action. In informal discussions from May through July of this year, the staff indicated that, without an approved hedging policy that specified otherwise, Northern's use or non-use of financial hedging instruments would be evaluated in the same manner as any of Northern's management or gas procurement decisions when determining whether associated costs would be allowed in rates. The company was told that it should act prudently in securing necessary gas supplies whether that requires the use of financial hedging instruments or not.

Northern initially indicated that, since Maine and New Hampshire "share" a gas supply portfolio, it would be necessary (and beneficial) to hedge for Maine while it did so for New Hampshire. However, Northern later indicated that it was not willing to execute financial hedges for the Maine part of the portfolio without prior review and approval of a hedging plan by the Maine Commission to avoid any adverse regulatory consequences or "second guessing" of its hedging decisions. Meanwhile, Northern developed a fixed price option (FPO) for its NH division and used financial hedging instruments to secure supply for that portion of its portfolio.

On August 15, 2001, Northern filed its proposed CGF for the Maine division. Its procurement strategy for Maine did not include any financial hedging instruments.

During the September 26, 2001 technical conference and in response to Advisor's Data Request 1-5 and 1-6, Northern discussed its hedging policy. In the Examiner's report, Staff noted that despite earlier indications that it would use financial instruments to hedge a portion of its Maine division's gas portfolio, Northern had not done so. Northern had entered into hedging agreements to support supplies offered under Fixed Priced Options (FPOs) for its New Hampshire customers. Northern asserted that all the financial hedging transaction costs are booked to its NH division.

III. DISCUSSION

Northern's rationale for not using financial hedges for any of the Maine division supply is that it did not have explicit assurances from the Commission that its financial hedging activity would be approved and that subsequent related costs would be included in rates.[4] Tr. A 59-62. At the September 26, 2001 initial case conference, Northern explained its decision as follows:

> MR. KIVELA: So you're not saying that the use of hedging instruments is only appropriate in a context of a fixed price offering. That it may in fact be appropriate in the normal course of business?
>
> MR. FERRO: Yeah, we certainly do agree that there's a place for employing hedging tools to stabilize customers' gas costs. However, in the regulatory -- under a regulatory structure, right now we were required to hedge for the fixed price option program in New Hampshire and conversely did not have any, as Chico said, guidelines or hedging policy parameters in place for all parties to review and agree on before going forward in employing those hedging practices.
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> MR. AUSTIN: Joe, just so that I'm clear, what I think you are saying is that even if you believed that it was clearly in the best interest of your Maine customers to hedge that you would not do so unless you already had some sort of a

[4] On September 28, 2001, Northern filed its proposed hedging policy with the Commission for review; the proposal is assigned Docket No. 2001-679. We will consider the merits of Northern's specific hedging proposal in that docket.

> hedging -- some sort of hedging guidelines approved by the Commission in place. Is that accurate?
>
> MR. FERRO: It is accurate, Tom, that we feel that the Company would be imprudent to its shareholders if in fact we went ahead without any authority of utilizing or following a hedging policy and put ourselves at risk for being subject to unrecoverable costs if the hedging results were not favorable.
>
> MR. AUSTIN: What has prohibited you from having a hedging policy in place in Maine?
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> MR. FERRO: We are -- what has prohibited us is that we just are now putting together a hedging policy that we want to file with the Commission. As far as coming up with a hedging policy, it involves a wide variety of issues Company-wide that we just haven't been able to really nail down yet.

Tr.A 60-61.

While there is no evidence in this record to support a finding that Northern's decision not to employ financial hedging instruments for the upcoming winter period has harmed Maine ratepayers, the soundness of the policy articulated by Northern here gives us reason for concern. We caution the Company that its view that it may forego doing what is in its customers' best interest merely because it is uncertain of the ratemaking treatment may not be a prudent position in all situations. The decision whether or not to hedge should be a conscious business decision made by the Company based on its own business judgment. The Commission cannot pre-approve every action a utility takes, and uncertainty of regulatory treatment should not impede otherwise prudent business decisions.

Northern made an informal inquiry to Staff on this subject last May and received an informal response. In further discussions in July, Staff told Northern that if it were not satisfied with the Staff's response, it should seek further clarification from the Commission. While we can appreciate that the initial decision to use financial hedging instruments is a significant one, we note that in prefiled (September 28, 2001) testimony in Docket No. 2001-679, Company witness DaFonte stated that one of its affiliates, Northern Indiana Public Service Company (NIPSCO), has been running a financial hedging program since 1996. DaFonte Dir. at 9. Therefore, a certain level of corporate expertise, from which Northern could directly benefit, already exists in this area. Furthermore, Mr. DaFonte stated that the financial hedging tools NIPSCO uses were "industry-recognized." We would interpret this to mean that the employment of such financial hedging tools is fairly common among players in the natural gas industry and that NIPSCO's program may be "recognized" as within the mainstream of such programs. Given these facts, we are concerned that Northern might knowingly place

Maine ratepayers at needless risk because it is unwilling to assume any level of business or regulatory risk that might be associated with the use of management tools, such as futures, options and swaps, that in the current environment could be considered to be "commonplace" and prudent business practice.

If a utility is uncertain about the regulatory treatment of a particular action, which rises to the level of significantly influencing its decisions, it has a number of alternatives available to it to reduce or eliminate that uncertainty, beginning, but not ending, with an informal inquiry at the staff level. In some circumstances, more formal action by the Commission may be warranted. See *Bangor Hydro-Electric Company, Request for Waiver from 35-A M.R.S.A. Section 902 to Enter Into Oil Price Hedge Agreements,* Docket No. 95-242, Order (Sept. 26, 1995) (hedge agreements deemed to be "evidence of indebtedness" and approved in an "umbrella" fashion with conditions designed to limit the Company's and its ratepayers' financial exposure.) When time is a factor, however, the utility has an obligation to act with sufficient speed in seeking Commission guidance to ensure that the result is not dictated by the passage of time rather than by a conscious choice.

Ultimately, it is within our regulatory purview, provided there are adequate supporting facts, to find Northern imprudent if it has not used financial hedging instruments in its gas procurement when it would have been sound business practice to do so. However, we can assure Northern (and its parent, NiSource) that we seek to be fair in our assessment of managerial decisions and would not "second guess" or discount Company decisions with the benefit of hindsight if reasonable when made. Rather, in the absence of clearer guidelines, we would review hedging decisions with precisely the same regulatory treatment as other contracts related to gas procurement or any other aspect of the utility business. In this regard, a decision to hedge is, in principle, no more likely to be judged imprudent as a decision not to hedge.

We acknowledge that finding a balance between prior regulatory confirmation of utility actions and timely use of managerial discretion is not always easy for utility management. Accordingly, we will review in Docket No. 2001-679 the question of whether we should establish a general policy on allowing LDCs to hedge without explicit regulatory guidelines, as well as the specific hedging program filed by Northern on September 28, 2001.

Dated at Augusta, Maine, this 13th day of November, 2001.

BY ORDER OF THE COMMISSION

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Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: Welch
Nugent
Diamond

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.

2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Appellate Procedure.

3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.